Volume 11 | Issue 2 | March 2014

European Commission

ISSN: 1725-8375

ECFIN Country Focus

ECONOMIC ANALYSIS FROM EUROPEAN COMMISSION'S DIRECTORATE-GENERAL FOR ECONOMIC AND FINANCIAL AFFAIRS

HIGHLIGHTS IN THIS ISSUE:

- *Macroeconomic performance is closely linked to the financial-services industry*
- *The "first mover" strategy has given a comparative advantage to Luxembourg*
- *Regulatory changes, competition and the slack in global growth have put pressure on the Luxembourg economic model*
- *The phasing-out of bank secrecy adds uncertainty to the future of private banking*

Private banking: Luxembourg's next growth engine?

By Diana Radu*

Summary

The financial sector lies at the heart of the Grand Duchy's economic landscape and banking activities have been the main driver of economic performance in Luxembourg over the last three decades. The development of Luxembourg as an international financial centre is related to its "first mover" strategy in implementing international regulation, low taxation and strict banking secrecy rules. The long-run prospects for the financial sector are closely linked to its ability to adapt to regulatory changes as well as to increased competition from other international financial centres. This Country Focus sheds some light on the expansion of private banking, an area where Luxembourg has traditionally been active in. While the phasing-in of the automatic exchange of information will also weigh on private banking, the extent of the impact of the new regulatory environment is still unclear. The small share of private banking in the Luxembourg economy and its potential for growth might mitigate, at least partially, the effects of the new regulation. In fact, the sector is already exploring new pockets of opportunity, being the "first mover" in targeting the Family Office niche and positioning itself as a provider of sophisticated services to complex profile clients.

Introduction

The international push for transparency has put the spotlight on countries like Luxembourg, which have made a commercial argument of banking secrecy. While it has resisted initiatives targeting banking secrecy in order to preserve its financial sector, the Grand Duchy has been looking for alternative candidates with growth potential. Private banking, accounting for 5% of the economy, has been a traditional pillar of the financial sector and its growth potential makes it a candidate area of expansion in Luxembourg.

This Country Focus starts by assessing the importance of the financial sector in Luxembourg and outlines the historical facts that underpinned and enhanced its development and current features. The importance of private banking and the role of the Grand Duchy in this area are explained. The options available for private banking in today's challenging context are also explored. The last section covers different scenarios for future developments.

**Economist at ECFIN.*

Economic and Financial Affairs

KC-XA-14-002-EN-N
ISBN 978-92-79-35116-7
doi: 10.2765/6883

Assessing the importance of the financial sector in the domestic economy

The development of the financial sector was made possible by the "first mover" strategy

The financial sector has been shaped by regulation

The financial sector is at the heart of the economy in Luxembourg and the banking has been the main driver of the economic performance over the last three decades. But the Grand Duchy's ascension as an international financial centre began already in the 1920s when it introduced a less restrictive banking regulation in comparison with other financial centres such as London or Zurich. Later on, the need for intra-sectorial diversification became evident when the exposure to banks proved to be too important during the 1980s Latin American debt crisis. During the same period, the European Union directives on the European passport for funds (Undertakings for Collective Investment in Transferable Securities – the UCITS regulation) were transposed in a flexible and rapid manner into Luxembourg law, a quick move that reinforced the specialization of the country in the fund industry. Over time, low taxation and the sophisticated products as well as tailored solutions attracted a broad, mostly foreign client base and allowed the development of support-related activities. The common feature of these developments is the "first mover" strategy applied by Luxembourg, as well as an attractive low tax environment.

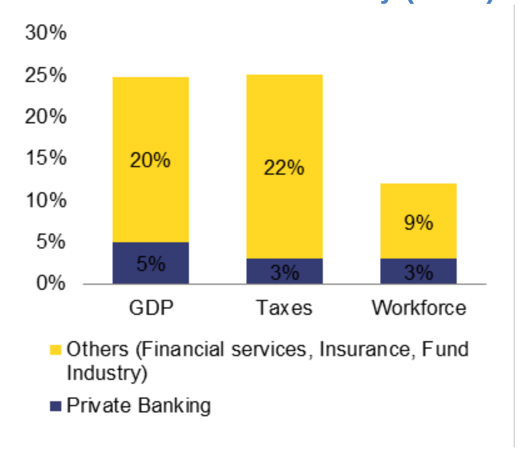
Three pillars make up the financial sector

In the December 2013 Country Focus "Luxembourg financial centre and its deposits", Wintersteller notes that the main pillars of the financial-services industry are financial intermediation, insurance and fund management. The operations are mostly cross-border as most credit institutions are cash-rich subsidiaries or branches of international groups acting as a conduit for lending abroad. Five system-relevant institutions of which three are domestic provide the bulk of funding for the domestic clients. And at the crossroads of financial intermediation, portfolio management and investment advice there is private banking, a traditional branch of the financial sector in Luxembourg.

The economy is highly reliant on the financial services

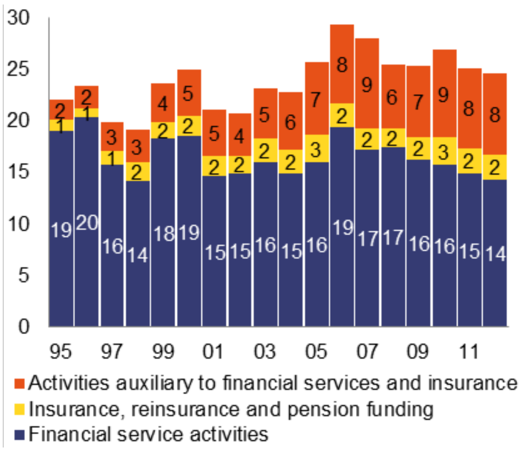
The direct economic contribution of financial services is very relevant in many aspects (Graph 1): contribution to value added (25% of GDP), to the fiscal revenues (25% of the total, according to ABBL) and to employment (12%). Despite having a declining economic impact since 2006, the financial and insurance activities continue to play a central role in the economy of Luxembourg. The decrease in the share of financial services should not be interpreted as an economic diversification away from finance but as a consequence of the financial and economic crisis (Graph 2). The development of the fund industry led to the development of activities that are auxiliary to the financial industry and today their share in total value added is significantly above the euro-area average (Graph 3).

Graph 1: Financial sector direct contribution to the economy (2010)



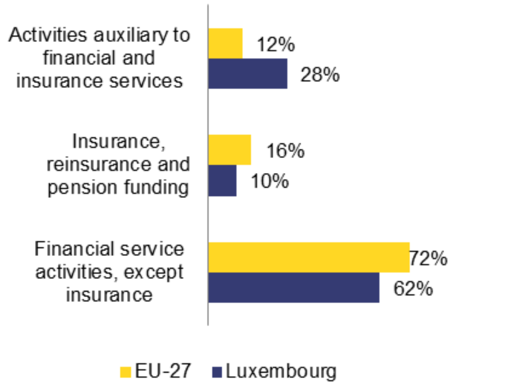
Source: STATEC, Luxembourg For Finance, own calculations

Graph 2: Luxembourg, Financial and Insurance Activities % of GDP



Source: STATEC (2013), own calculations

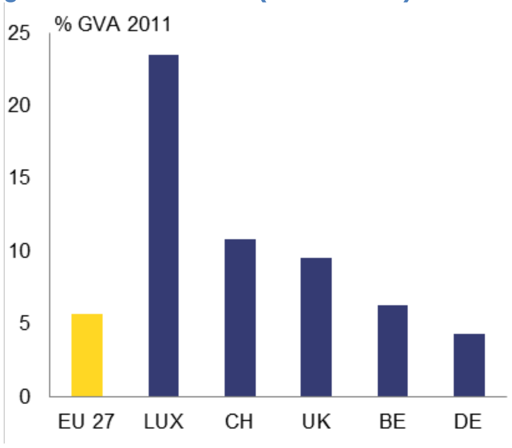
Graph 3: Financial Subsectors (% of Sectoral Value Added, 2012)



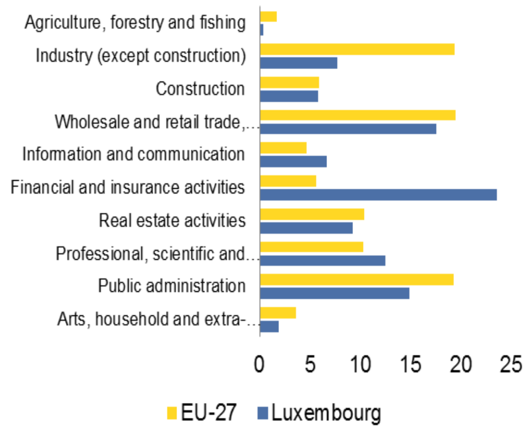
The overall contribution of the financial sector to the economy is large but...

When compared with other countries specialized in finance, Luxembourg stands out as highly dependent on its financial sector (Graph 4), which represents a large share of GDP compared to the other sectors of the economy (Graph 5). In absolute terms, the contribution of the financial sector to value added in 2011 was up to EUR 149 billion in the UK, EUR 100 billion in Germany or EUR 48 billion in Switzerland, while the contribution of EUR 9 billion in Luxembourg was not as impressive. Although representing a quarter of total value added, diminishing the share of the financial sector represents a big challenge for a small economy with limited resources like Luxembourg. From this perspective and taking into consideration the new financial regulation, focusing on more lucrative niches and with higher growth potential is a promising avenue to be explored in Luxembourg. Private banking is one of the most suitable candidates within the financial sector for at least three reasons. First, Luxembourg can build on the already-existing experience, products and legal framework. Secondly, the revenues in private banking are still high compared to other financial activities where the margins continue to shrink. Finally, private banking still has the potential to expand based on the projections for growth of new investable wealth.

Graph 4: Financial sector as % of total gross value added (GVA 2011)



Graph 5 Value added by sector as % of total gross value added (2011)



Source: EUROSTAT, STATEC (2013)

...less striking for private banking

Because there is no clear identification in the national accounts of private banking activities, the latter's revenues are estimated to obtain an indication about the role and weight of private banking in Luxembourg. The conclusion is that the private banking activity has a rather modest direct contribution to the overall result of the financial industry (5% of GDP, 3% in taxes[1]) (Graph 1). Yet, at the sectoral level, the interactions with other market players like investment firms, banks and insurance companies, for which it represents an important source of revenue, imply that private banking is significant for the financial sector.

The place of private banking in Luxembourg

Private banking is one of the traditional financial sector activities

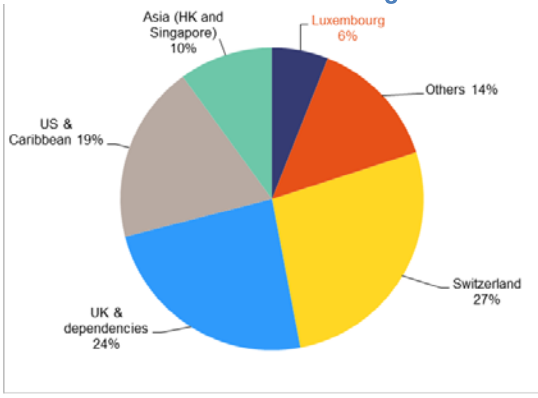
Private banking can be seen as an investment-advisory branch of financial services, incorporating retail banking, financial planning, portfolio management, legal resources, and tax and investment advice. It can be performed by banks, wealth managers (part of the professionals of the financial sector (PFS)[2]) or Family Offices[3]. It targets the share of the global wealth that is investable, either onshore or offshore, and it is addressed to high-net-worth individuals, small-business owners and well-off families. Offshore wealth is defined as the assets booked in a country where the investor has no legal residence or tax domicile. The revenues in private banking are generated by fees. In good times, financial market activity driven by risk appetite would boost the transaction-based fees, while the appreciation of assets and the new inflows would increase the asset-based fees.

Luxembourg has traditionally been active in private banking. For a long time, a combination of macroeconomic stability, friendly business environment, sound business practices, low taxes and strict banking secrecy rules (Article 458 of the Criminal Code) has been the recipe that attracted flows into the banks. Furthermore, the confidentiality that guided the business relationships, the stricter tax policies in neighbouring countries and the expertise of the local workforce and elaborated product offer reinforced the growth of private banking from the 1980s onwards.

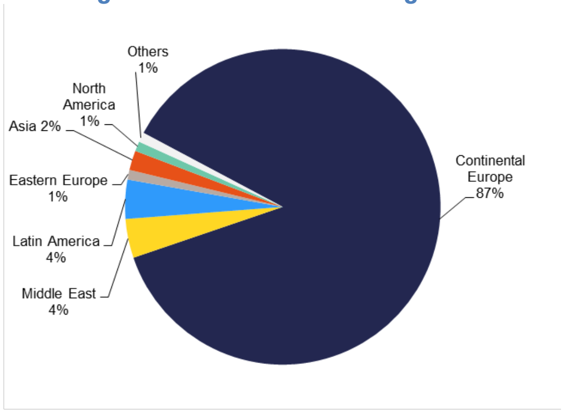
The place of Luxembourg in private banking

According to Private Banking Group, Luxembourg, private banking in Luxembourg reached EUR 305 billion in 2012, or roughly 6% of the global offshore wealth (Graph 6), rising slightly from EUR 300 billion in 2011 and divided among private banks (79%), wealth managers (18%) and Family Offices (3%). Luxembourg initially attracted mainly small-to-medium-sized clients from Belgium, France and Germany because of its tax system. A decade ago, these three countries represented 90% of the offshore assets but, over the last ten years, the local private banking sector diversified internationally and their share fell to 56%. Today Luxembourg is still oriented towards continental Europe with 87% of the total assets being European (Graph 7). Despite being the leader in private banking in the euro area, the Grand Duchy is far smaller in terms of assets compared to its neighbouring competitor, Switzerland, which is five times larger.

Graph 6: Share of Luxembourg in international Private Banking



Graph 7: Geographic origin of Private Banking clients in Luxembourg



Source: Private Banking Group, Luxembourg(2011)

The shaping power of regulatory changes

Increased pressures on financial centres: competition, regulation, service

The structure of the financial sector, as well as its contribution to the national economy, is a reflection of the development strategy adopted by Luxembourg. More recently, and especially since 2008, the industry has embarked on a series of adjustments in order to meet the new global banking rules setting the capital adequacy framework (Basel III). The global financial crisis and fiscal consolidation in many countries have put an emphasis on fairness and led to a global push for more transparency in order to maximize tax revenues (the United States Foreign Account Tax Compliance Act-FATCA, the European Directive 2003/48/EC on the taxation of interest income from savings). Furthermore, in November 2013, Luxembourg failed the transparency test performed by the Global Forum on Transparency and Exchange of Information for Tax Purposes overseen by the OECD. In addition to the regulation changes, tougher business conditions, increasingly demanding clients and growing international competition from other financial centres present considerable challenges to the market share of Luxembourg in private banking.

Different initiatives indicate that the Grand Duchy is becoming increasingly aware of the need to act in order to realign economic interests and national choices with international acceptance. In 2009, Luxembourg adhered to the OECD standards on the exchange of financial information upon request by competent foreign authorities. Since April 2013, 10 years after the adoption of the Directive 2003/48/EC on the taxation of interest income from savings, Luxembourg decided to end the transitional period that it benefited from and to introduce the automatic exchange of information in tax matters with competent government tax authorities. This will be in place as of 1 January 2015. With most of the ingredients that underpinned the development of private banking in Luxembourg surviving the crisis, the formula needs to be updated taking into account the new standards on transparency.

Three steps to achieve expansion in private banking: target high-net-worth and ultra-high-net-worth individuals; retain existing clients; attract newly-created wealth

Private banking is undergoing a refocusing phase that seeks to lock-in the potential for growth of this activity. In this sense, to attract newly created wealth seems to be an important element. A recent trend is for private banks in Luxembourg to establish subsidiaries in the country of residence of their clients in order to retain the clients and preserve the client relationship. Defining the target clients and retaining existing clients that match the target client profile also appear as options explored by Luxembourg in the area of private banking. The sophisticated and diverse offer of products, expertise and high-quality services fitted to clients looking for cross-border expertise are arguments for Luxembourg to retain existing clients. In this area, its advantage lies also in the technical expertise in investment funds that can be re-directed to private banking.

From a growth perspective, the industry in Luxembourg seems to attract both rich and very rich individuals as shown by the size of the assets by client account (PBGL) (Graph 8). The smaller clients are considered to be more profitable but less stable while the bigger clients' assets should compensate for their stronger negotiating position.

Graph 8: Average Assets by Client Account

Private Banks	EUR 1.06 million
Wealth Managers	EUR 0.76 million
Family Offices	EUR 203 million

Source:Private Banking Group Luxembourg (2011)

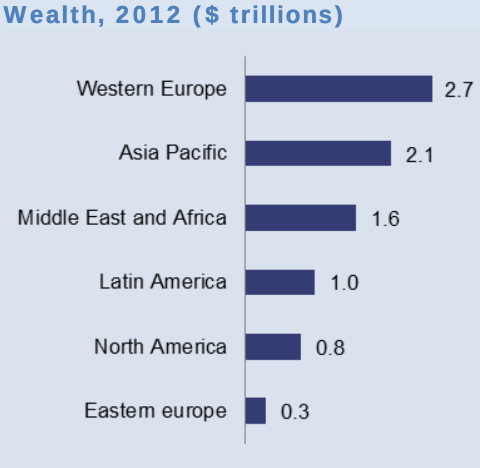
As regards geographical focus, Luxembourg seems to show a stronger presence in Europe, the Middle East and Africa. Having a stronger foothold and access to the newly-created wealth in these regions is something a well-known European financial centre like Luxembourg can achieve. However, being less prominent in Asia and Latin America is likely to limit its potential for expansion in these faster growing regions.

Private banking expansion depends largely on offshore wealth creation

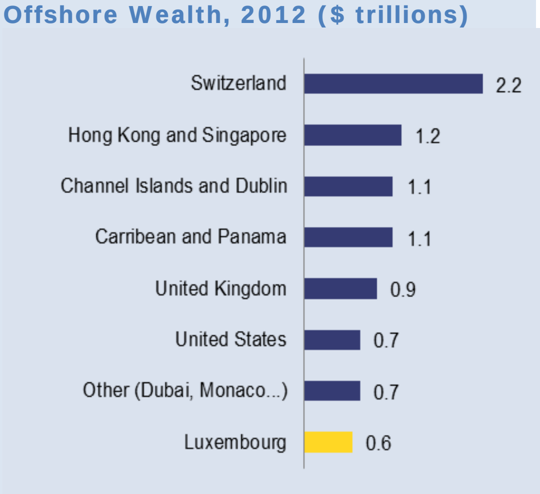
Box 1: Newly created wealth by origin and destination

According to Boston Consulting Group, managed offshore wealth worldwide (assets booked in a country where the investor has no legal residence or tax domicile), amounted to USD 8.5 trillion in 2012, originated mainly from Western Europe (Graph 9), Switzerland being the most popular destination (Graph 10). The projections of Boston Consulting Group for the newly created offshore wealth by 2017 are of $1.4 trillion for Asia Pacific, USD 0.5 trillion for Latin America, USD 0.5 trillion for the Middle East and Africa and USD 0.2 trillion for Eastern Europe or an average 6.5% annual growth rate.

Graph 9: Origin of Global Offshore Wealth, 2012 ($ trillions)



Graph 10: Destination of Global Offshore Wealth, 2012 ($ trillions)



Source: Boston Consulting Group Global Wealth Market-Sizing Database (2013)

"First mover" in the Family Offices

Without forgetting the strategy that ensured its success over the years, in December 2012, the Parliament passed a law by which Luxembourg became the first EU member state to offer a regulatory framework for the activities of the Family Offices. A Family Office is a form of private banking under which an entity provides -on a professional basis- a wide range of services for well-off clients belonging to the same family. The Family Offices activities have a wide scope and cover patrimonial planning and structuring, administrative and financial follow-up including legal services as well as tax planning and accounting support. With this move, Luxembourg is attempting to create once again the "first mover" advantage with the aim of accessing this client niche. In 2009, there were 30 Family Offices in Luxembourg but, given the legislative developments, their number is likely to increase.

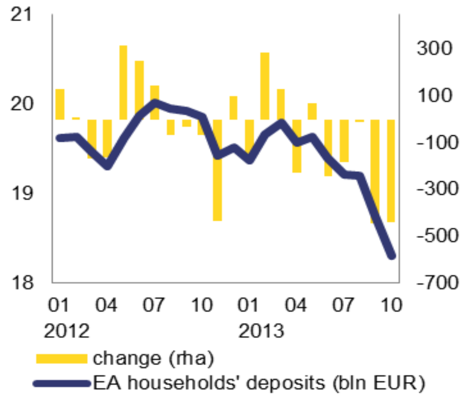
Can private banking have a sizeable impact on growth?

The contribution of private banking to the economy is a function of exogenous factors such as market conditions or new investable wealth creation, but also of the strategy chosen by Luxembourg. From a macro-financial perspective, the automatic exchange of information is expected to have an impact on private banking and on GDP. In this section, the potential size of this impact is assessed based on market participants' expectations as well as on the observable data available and the outcomes from three different possible scenarios.

Deposits decreased following the April 2013 statement on the Directive 2003/48/EC and the automatic exchange of information

The impact of the introduction of the automatic exchange of information in January 2015 is difficult to evaluate as the extent the decision to make deposits in Luxembourg has been influenced by banking secrecy is uncertain. Although no abrupt adjustment has taken place so far, the latest statistics on deposits of European Union households published by the Banque Centrale Luxembourg and the only observable change to date show a decrease of EUR 1.48 billion between April and October 2013. This is less than 1% of the EUR 305 billion assets under management in private banking and 8% of EA households' deposits but it might be attributed to the announcement of the decision to introduce the automatic exchange of information as of fiscal year 2015.

Graph 11: Dynamics of Euro Area Households' Deposits in Luxembourg banks



Source: Banque Centrale du Luxebourg (2013), own calculations

The potential of private banking to be the next economic growth driver in Luxembourg can be assessed under three scenarios which also allow the front-loaded impact of the new regulatory environment to be taken into account. A **central scenario** would consist of a moderate growth rate of 2% in private banking, in line with projections for the private banking activity and with the last five year average inflows in Western Europe. It would result, *ceteris paribus*, in an annual direct contribution to growth of around 0.10 pp, which is relatively low and insufficient to turn private banking into a new "growth driver". In an **unfavourable scenario**, should the outflows anticipated by private bankers materialise, the contribution of private banking to GDP might decrease by as much as 1.5 pp. The direct impact would be on transaction-based and asset-based fees that would decrease mechanically. Adding to these outflows, the exceptionally low rate environment, which puts the margin on deposits under pressure, and the high cost-to-income ratio are additional elements that private banks would have to factor in when choosing their strategy. This would be a rather bleak scenario and it illustrates the importance for Luxembourg to focus on developing the right strategy.

Important potential for growth in private banking

The **third scenario** is for private banking to be a significant growth driver. For this, the assets under management in private banking would have to grow by at least 7% per year, which is a strong but achievable rate, as can be deduced from the average wealth-creation rate presented above. This would allow private banking to add around ½ pp to GDP growth per year. The spillover effects from a thriving financial sector are well-known for the Luxembourgish economy and have long been the driver of its dynamism. Private banking is an important source of revenues for banks, the fund industry and insurance and its growth will indirectly boost their results. In order to preserve its 5% share in the global private banking business and the high and stable revenues from it, support could come from the growth potential of worldwide offshore wealth, projected to increase by USD 2.6 trillion by 2017 (Box 1). There are, however, important challenges stemming from increased competition, toughening regulation, rising costs and declining profit margins.

Conclusion

The changes in regulation that allowed its development as an international financial centre become the challenges that Luxembourg has to deal with in the coming years. The new rules on transparency will directly impact private banking and the domestic economy, which relies on the performance of its financial sector. Although a game changer, the new regulations also represent an opportunity for Luxembourg to explore new strategies in the same vein as during the last decades through a "first mover" approach. Private banking can be an activity with growth potential and Luxembourg will have to strike the right balance between continuing the development of its financial sector and pursuing efforts for a further diversification of the economy.

References

BCG (2013) Boston Consulting Group "Maintaining momentum in a complex world";

Edouard Franklin (2010) "Etude. Le marché de la gestion de fortune à Luxembourg en 2009";

European Fund and Asset Management Association (May 2012) "European Fund and Asset Management Association: Asset management in Europe. Facts and figures";

European Fund and Asset Management Association (May 2013) "European Fund and Asset Management Association: Asset management in Europe. Facts and figures";

The Financial Times (May 7, 2013) "Switzerland: Haven feels pressure to conform with global data sharing rules";

KPMG (2012) "Performance through focus. Seizing the global private banking opportunity";

Luxembourgforfinance (2012) "Etude d'impact de l'industrie financière sur l'économie luxembourgeoise";

McKinsey (July 2012) "McKinsey Private Banking Survey 2012. Finding a new footing";

McKinsey (2011) "2011 McKinsey Private Banking Survey. First signs of renewal";

OECD (2009) "Can the financial sector continue to be the main growth engine in Luxembourg?";

Luxembourg Ministry of Finance FAQ "Introducing automatic exchange of information in Luxembourg";

PwC (December 2011) "Pricewaterhouse Coopers: Banking in Luxembourg";

Saxton, Nicholas and Christensen, John (2013) "The Finance Curse";

STATEC (Nov 2013) "Conjoncture Flash Novembre 2013";

Wintersteller, Markus (2013) "Country Focus Luxembourg's financial centre and its deposits".

[1] Luxembourgforfinance estimate.
[2] The professionals of the financial sector (PFS) are regulated entities offering non-banking financial or complementary services and benefiting of Article 41 of the Law of 05 April 1993 which regulates professional confidentiality of finance industry professionals. PFS fall into three main groups: investment firms, specialized PFS and support PFS.
[3] A Family Office is a form of private banking by which an entity provides on a professional basis a wide range of services for well-off clients belonging to the same family.